

IT 01-8

Tax Type: Income Tax

Issue: Unitary Apportionment

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

"ABC INSURANCE MARKETING, INC.",
Taxpayers

No. 97-IT-0000
FEIN: 00-0000000
Tax yrs: 12/31/92, 12/31/93,
12/31/94

Charles E. McClellan
Administrative Law Judge

RECOMMENDATION FOR DECISION

Appearances:

Sean Cullinan and James Newbold, Special Assistant Attorneys General, for the Department of Revenue; Mary Kay McCalla Martire and Michael H. Woolever of Hopkins & Sutter for "ABC Insurance Marketing, Inc." and "Universal Claim Administrators, Inc."; Robert S. Markin of Altheimer & Gray for J. Lee Covington II, Superintendent of Insurance for the State of Ohio, liquidator of "Apex Life Insurance Company".

Synopsis:

This matter involves timely protests to Notices of Deficiency mailed by the Department of Revenue to a group of companies that filed combined Illinois income tax returns for the years at issue, 1992, 1993 and 1994.¹ The companies are

¹ Taxpayer files its income tax returns on a calendar year basis.

"Universal Claims Administrators, Inc.", ("UCA"), the parent corporation, and "ABC Insurance Marketing, Inc." ("ABC"), "Apex Life Insurance Co." ("APEX"), and "Associated Insurers Association" ("AIA"), its subsidiary corporations. The Notices of Deficiency are based on the Department's determination that these corporations are not unitary so they should have filed separate income tax returns rather than combined returns. On the separate filing basis determined by the Department, "UCA" and "APEX" have overpayments for 1992 and 1993, so the taxpayer filed protective refund claims that the Department denied and the taxpayer protested.

On November 9, 1999, eight days before a scheduled evidentiary hearing, the Department of Revenue filed a motion for partial summary judgment on the issue of whether the taxpayer could reallocate items of income and expense between related corporations under Section 404 of the Illinois Income Tax Act² or whether that authority was limited to the Director. On November 15, 1999 at the hearing on the Department's motion, an order was entered granting the taxpayer's request to address the issue raised in the Department's motion in its post-hearing brief. The issue raised in the Department's motion is included in the pre-trial order previously entered on November 13, 1998 and it was addressed at the hearing and in the post-trial briefs.

The pre-trial order listed the following issues. to be addressed at the hearing:

² Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq.*, the Illinois Income Tax Act ("IITA" or "the Act").

1. **Whether the income of "ABC" should be apportioned under IITA § 304(b).**
2. Whether "ABC Associates, Inc." ("ABCA"), the holding company of ""UCA"", was part of an Illinois unitary group.³
3. Whether allocation or alternative apportionment is appropriate for "UCA".
4. Whether income of "ABC", "UCA", or "APEX" should be reallocated pursuant to IITA § 404.
5. Whether "Associated Insurers Association, Inc." ("AIA") should be included in taxpayer's unitary group.
6. Whether penalties imposed under IITA § 1005 should be waived for reasonable cause.

Another issue, not mentioned in the pre-trial order, was raised by the taxpayer at the hearing. That issue is whether income characterized by the Department's auditor as re-insurance income for 1993 and 1994 should be included in the "APEX" apportionment formula for each of those years.

An evidentiary hearing was held on November 17, 1999. Both parties filed post-hearing briefs. After the last brief was filed on January 10, 2000, but before a recommendation was completed, a liquidator was appointed by the Court of Common Pleas of (Someplace) County, Ohio for "APEX" and an order of liquidation was entered on May 8, 2000. The liquidator's attorney filed a motion to dismiss "APEX" from these proceedings on July 18, 2000 alleging that the Department is barred by statute in Ohio and

Illinois from further prosecution of any civil action against "APEX". Following negotiations with the liquidator, the Department and the liquidator entered into an agreed order filed on May 21, 2001, later corrected by an agreed order filed on July 3, 2001, wherein the Department agreed that the "APEX" assessment will not exceed \$123,443 and "APEX" withdrew its protests to the Notice of Deficiency.

I recommend the following: (1) that the Department's motion for partial summary judgment should be stricken; (2) the Notices of Deficiency should be revised to eliminate "AIA" from the combined returns for 1993 and 1994; (3) the reinsurance premiums should be eliminated from the apportionment formulae; (4) the Notices of Deficiency issued to "AIA" for 1993 and 1994 should be made final; (5) except as noted above, the unitary group of "UCA", "ABC" and "APEX" should be left intact and the Notices of Deficiency, the Notice of Overassessment and the Notices of Claims Denial should be recalculated, subject to the limitation of the assessment against "APEX" of \$123,442 as specified in the July 3, 2001 agreed order.

Finding of Facts:

1. "ABC" was a holding company and the parent of "UCA".⁴ Tr. p. 31.
2. "UCA" was an insurance holding company incorporated in Delaware. Tr. pp. 31-32.
3. "UCA" had no tangible assets and no employees during the tax years. Tr. pp. 62, 87, 90.

³ This issue seems to have been included erroneously in the order since "ABC" is not referenced in any of the Notices of Deficiency that are involved in this matter. Also, it was not addressed at the hearing.

⁴ All findings of fact refer to the time period at issue unless another time period is specifically identified.

4. In addition to "UCA", "ABC" owned other corporations engaged in many other businesses including real estate, boats, printed shirts, and a pepper plantation. Tr. pp.85-86; Taxpayer Ex. No. 8, pp. 4-6.
5. "ABC" filed consolidated federal income tax returns that included "UCA" and its subsidiary corporations as well as its other subsidiary corporations that are not involved in the insurance business. Taxpayer Ex. No. 8, pp. 4-6.
6. "APEX" was an insurance company domiciled in Ohio, with its principal place of business located in (Someplace), Illinois and it was licensed to sell insurance in 38 states. Tr. pp. 29, 58.
7. "APEX" is engaged in the business of writing health insurance for small groups and individuals, in part through the endorsements of local chambers of commerce. Tr. pp. 29 –33, 67- 68, 87.
8. "APEX" had about 385 employees at the time of the hearing in this matter. Tr. p. 30
9. "ABC" was incorporated in Delaware. Tr. p. 32.
10. "ABC" had no assets and no employees. Tr. pp. 32, 69-71, 87, 90.
11. "ABC" and "APEX" were wholly owned subsidiaries of "UCA". Tr. p. 32.
12. "UCA" filed combined Illinois income tax returns that included a number of affiliates including "APEX", "ABC", and, for 1993 and 1994 only, "AIA". Tr. pp. 31, 84-89; Taxpayer Group Exs. No. 8 –10.
13. "AIA" was not properly included in the combined returns for 1993 and 1994 as filed. Taxpayer brief p.8, n.5.

14. Prior to 1985, "UCA" was in the business of marketing and administering insurance for third parties. Tr. p. 62.
15. Neither "UCA" nor "ABC" were licensed to sell insurance. Tr. pp. 78-79.
16. On January 1, 1985, "UCA" and "APEX" entered into an agreement under the terms of which "UCA" agreed to provide certain marketing and administrative services to "APEX" in connection with its health insurance policies. Tr. p. 52; Taxpayer Ex. No. 7.
17. "UCA" never performed the services provided for in the January 1, 1985 agreement because it had no employees or property. Tr. pp. 52-53, 91-92.
18. All of the services required by the January 1, 1985 agreement were performed by "APEX". *Id.*
19. During 1985, "UCA" transferred all of its responsibilities for marketing and administrative services to "APEX" and it ceased being a third party administrator. Tr. pp. 62-63; Taxpayer Ex. No. 6.
20. The income and expenses reported for "ABC" were the result of intercompany accounting entries transferring estimated amounts of income and expense from "APEX" to "ABC". Tr. pp. 93-94, 122-126.
21. "ABC" never had any employees nor did it ever conduct any marketing activities. Tr. pp. 95-96
22. Because "APEX" was licensed to sell insurance in only 38 states, it entered into "fronting agreements" with companies that were licensed in those states. Tr. pp. 58-60; Taxpayer Ex. No. 18.

23. Under these fronting arrangements, the licensed companies sold insurance for a percentage of the premium, but "APEX" assumed the entire risk. Tr. pp. 55-59; Taxpayer Ex. No. 18.
24. "APEX" included the premiums from these fronting agreements in its apportionment factor and the Department's auditor excluded them as premiums from re-insurance agreements. Tr. pp. 163-164.
25. All income earned and reported on the "UCA" combined Illinois income tax returns was earned and collected in the form of insurance premiums by "APEX" which was the only company in the unitary group with employees. Tr. pp. 87-88.
26. The insurance premiums were all billed and collected by "APEX" and its employees performed all of the marketing functions, claims administration and other administrative services. Tr. p. 100.
27. On March 28, 1997, the Department mailed a notice of over assessment to "UCA" for the years 1992 and 1993. Dept. Group Ex. No. 1.
28. Also, on March 28, 1997, the Department mailed Notices of Deficiency to a number of companies that "UCA" included in its combined returns as follows:

| <u>Company name</u> | <u>Tax Years</u> |
|---------------------|------------------|
| "UCA" | 1994 |
| "AIA" | 1993, 1994 |
| "APEX" | 1992, 1993 |
| "ABC" | 1992, 1993, 1994 |

Dept. Group Ex. Nos. 2-5.

29. Prior to 1985, "UCA" was engaged in the business of providing third party administrative services to various third parties under the terms of arms length agreements. Tr. pp. 62, 92.
30. A third party administrator is an entity licensed by the state Department of Insurance to provide services to an insurance company; such services include billing and collecting of premiums, determining the eligibility of claims, claims processing and payment, marketing and sales functions and other administrative services the insurance company might require. Tr. pp. 37, 141–142.
31. An insurance company can accomplish, by using its own employees, all of the functions provided by a third party administrator. Tr. p. 38.
32. Marketing is essential to the health insurance business because the business is based on the law of large numbers, which means that the larger the number of policyholders, the more predictable the risk of claims liabilities. Tr. pp. 64 – 65.
33. Every month, between 3 ½% to 4% of "APEX's" policies lapse or terminate leaving only the less healthy people covered, so that it is essential to keep replenishing the pool of people insured. Tr. pp. 65–68.
34. On January 1, 1985, "UCA", "APEX", and "Rescue Life Insurance Company"⁵ entered into a marketing agreement under the terms of which "UCA" transferred all of its third party administrative services responsibilities to "APEX". *Id.*; Taxpayer Group Ex. No. 6.

⁵ "Rescue Life Insurance Company" is an unrelated life insurance company domiciled in Texas.

35. After "APEX" acquired the third party administrative services business from "UCA", "UCA" was a corporate shell with no assets and no employees. *Id.*; Tr. pp. 62, 95.
36. On January 1, 1985, "APEX" entered into another agreement with "UCA" in which "UCA" agreed to perform the marketing services for "APEX" in connection with its health insurance policies ("the marketing agreement"). Tr. p. 52; Taxpayer Group Ex. No. 7.
37. The marketing agreement was a type of marketing agreement that was common in the insurance industry insofar as the services that were to be provided to the insurance company. Tr. pp. 53, 150.
38. The marketing agreement was in effect during the tax years, but "UCA", being a shell corporation with no employees, never performed any services under this agreement. Tr. pp. 52, 91, 92.
39. All of the marketing and other services of the type provided for in the marketing agreement were provided to "APEX" by its own employees. Tr. p. 91.
40. None of the income or expense related to these marketing services was recorded on books of "UCA". Tr. p. 92.
41. The reason that the marketing agreement was left in place even though "APEX" was conducting its marketing activities with its own employees was to protect the "UCA" name which was thought to have brand name recognition in the market developed during the days when "UCA" was a third party administrator providing marketing services for third parties. Tr. pp. 92-93.

42. All of the income earned and reported on "UCA's" combined return for the tax years was earned and collected by "APEX". Tr. pp. 64, 88.
43. Neither "UCA" nor "ABC" performed any services in connection with "APEX's" insurance business during the tax years. *Id.*
44. The compensation payable under the marketing agreement between "UCA" and "APEX" was attributed to "ABC" by intercompany accounting entries. Tr. p. 94.
45. All of the administration, the premium billings and collections were reflected on the books of "APEX". Tr. p. 100.
46. The amount of compensation recorded on the books of "ABC" by the intercompany transfers does not reflect the level of profit that would be expected in an arms-length transaction negotiated by unrelated companies engaged in this type of insurance business activity in a free market. Tr. pp. 150-152.

Conclusions of Law:

This matter involves a number of issues as set forth in the pre-trial order relating to allocation and apportionment as well as to whether "UCA", "ABC" and "APEX" are a unitary group entitled to file a combined income tax return. If a combined return is proper, the only other issues that need to be addressed are the reinsurance premiums issue and the penalty issue, so, first, I address whether "UCA", "ABC" and "APEX" are a unitary group.

The Unitary Group Issue

"UCA", "ABC" and "APEX" filed combined Illinois income tax returns as a unitary business group engaged in the insurance business, so they apportioned the business income

using the single factor of insurance premiums written in Illinois as a percent of total insurance premiums written as required by IITA § 304(b).

The Department argues that "ABC" is a separate corporation that is not in the business of selling insurance so it is required to apportion its income using the three factor formula specified in IITA § 304(a). If that is the case, it cannot be included in a unitary group with "APEX", an insurance company required to apportion its income using the single direct premium factor specified in IITA § 304(b).

Taxpayer argues that "ABC", having no employees or property, did not perform the functions that produced the income which the taxpayer transferred to "ABC" from "APEX". Taxpayer argues that all of the functions attributed to "ABC" by the Department were actually performed by "APEX" which is a licensed insurance company.

The Department's determination that "UCA", "ABC" and "APEX" are not unitary ignores the facts of this case. In arriving at his determination, the Department's auditor stated that he considered only three factors. First, "ABC" received commissions but reported no premium income. Second, "ABC" did not file an annual statement with the Illinois Department of Insurance. Third, "ABC" did not report premium income on its federal income tax return. (Tr. pp. 162-163.)

The Department's determination disregards the fact that all of the income and expenses attributed to "ABC" were derived from premiums earned and expenses incurred by "APEX" from selling insurance and collecting related administration fees. (Tr. pp. 88-89) Also, the commission income shown as being received by "ABC" was not retained by "ABC". It was "just a pass through wash" collected by "APEX" and distributed to the

"APEX" agents by "APEX". (Tr. p. 102; Taxpayer Ex. Nos. 8-10) Third, the income and expenses attributed to "ABC" were reported to the Illinois Insurance Commission on the annual reports filed by "APEX". (Tr. pp. 88-89)

The testimony of the Department's auditor indicates that he completely ignored the facts relevant to the way the insurance business of "APEX" was conducted. He did not consider that "ABC" was a shell company. He did not consider that the financial transactions attributed to "ABC" resulted from intercompany accounting transfers. He simply accepted the numbers as they were reported. Tr. p. 167. He disregarded the fact that "ABC" had no employees or property. *Id.* He did not consider the fact that "ABC" had no contract to do any marketing work. *Id.* He could not remember whether he was told that "UCA" was a shell with no employees and no property, but he did remember that "APEX" did all of the work for "UCA". Tr. p. 168. He was aware that "ABC" was not an insurance brokerage. *Id.* He did not notice that the profit margins attributed to "ABC" were more than normal third-party profit margins. Tr. p. 169. He also knew that all of the income of the three companies came from the collections of premiums and related administrative fees by the "APEX" employees. Tr. pp. 169-170.

The Department's argument that "ABC" was a three-factor apportionment company ignores the reality that it had no employees or property with which it could conduct any business operations. The financial information attributed to "ABC" was the result of accounting entries transferred from the accounts of "APEX". The terms of the underlying agreements and the testimony of the controller regarding the estimates of expenses for marketing indicate that these numbers were pure fiction. The taxpayer's witnesses could

not explain why "UCA" has no employees but has a marketing agreement with its own subsidiary to perform marketing services. Nor could they explain why the billing and commissions are reported on the books of "ABC" which has no employees, is not an insurance brokerage and has no contract with "APEX" to perform the market services that are actually being provided by "APEX" employees.

The record is not clear as to why taxpayer maintained this accounting fiction. Tr. p. 92. It had no effect on external financial reporting which was on a consolidated basis, or on federal income tax reporting which was also on a consolidated basis. Tr. pp. 93-95. Except for the allegations of the Department in this case, it had no effect on state income tax reporting in other states. Tr. p. 98. Since all of the business activity of "UCA", "ABC" and "APEX" was conducted in "APEX", the combined returns as filed were proper except for the inclusion of "AIA", which the taxpayer agreed was in error. Filing on a combined basis reflected the fact that "UCA", "ABC" and "APEX" were a unitary business group.

The IITA defines a unitary business group as being a group of persons related through common ownership, the business activities of which are integrated with each other and whose business activities are dependent upon and contribute to each other. IITA § 1501(a)(27). Unitary business activity is demonstrated where the activities of the members are in the same line of business, *e.g.*, insurance. *Id.* In a unitary business group there is strong centralized management and functional integration. *Id.* A member cannot be included in a unitary group with other members that are required to apportion business income under different subsections of Section 304.

In addressing the question of whether income is apportionable, the U.S. Supreme Court has stated that it looks to the “underlying economic realities of a unitary business”. Exxon Corp. v. Dept. of Revenue of Wisconsin, 447 U.S. 207, 100 S. Ct. 2109 (1980) The evidence of record clearly establishes the underlying economic realities of the business involved in this case. All of the income from the insurance business carried on by the three companies was earned by "APEX".

Applying the statutory tests of IITA § 1501(a)(27) to the facts of this case leads to the conclusion that including "UCA", "ABC" and "APEX" in a combined return as a unitary business group was proper. On paper, the three companies all appear to be involved in the insurance business. "UCA" and "ABC" did not perform any business operations, however, because they had no property or employees to conduct any business. Both of them were empty corporate shells. All of the business activity of these three legal entities was conducted by "APEX". Therefore, there was centralized management and functional integration because the entire business was conducted, managed and controlled within "APEX" by "APEX" employees.

The Reinsurance Premium Issue

The next issue to be considered is whether the income characterized by the Department’s auditor as re-insurance income for 1993 and 1994 should be included in the "APEX" apportionment formula for each of those years.

IITA § 304(b) sets forth the apportionment formulae to be used by insurance companies. IITA § 304(b)(1) prescribes the general rule of apportioning business income by insurance companies as being a fraction in which direct premiums written on property

or risks in Illinois is the numerator and direct premiums written on property or risks everywhere is the denominator. IITA § 304(b)(2) provides for inclusion of reinsurance premiums in the apportionment formula if the principal source of premiums written by the taxpayer is for reinsurance accepted by it.

The Department's auditor stated that the term "principal source" means that reinsurance premiums must be over 50% of taxpayer's total premiums. Tr. p. 164. The auditor stated that "APEX's" reinsurance premiums as reported on the its Schedule T filed with the Illinois Insurance Commission did not exceed 50% of the total premiums for any year in the audit period. *Id.* For that reason, he concluded that reinsurance was not the principal source of premiums for the taxpayer, so he excluded the reinsurance premiums from the apportionment formula. The parties do not dispute the fact that the reported reinsurance premiums did not exceed 50% of the total premiums nor that reinsurance premiums must be over 50% of total premiums to be included in the insurance company apportionment factor. The only issue is whether the premiums reported as reinsurance premiums are in fact reinsurance premiums.

Taxpayer argues that the income reported by "APEX" on schedule T as reinsurance premiums consists of premiums received through "fronting agreements", not reinsurance premiums. As such, taxpayer argues, they are direct premiums so they do belong in taxpayer's apportionment factor.

A fronting agreement is a reinsurance device, used by a company that is not qualified to write insurance in a particular state, to profit from selling insurance in that state. Union Savings American Life Insurance Company v. North Central Life Insurance

Co., 813 F. Supp. 481 (U.S.D.C., S.D. Mississippi 1993). A fronting arrangement is established when a licensed carrier issues a policy to a company ("the carrier") and the company promises, in return, to assume whatever risk the carrier has assumed under the policy or to reimburse the carrier for whatever amounts it is required to pay out under the policy. In return, the company agrees to pay the carrier a fronting service fee below the cost of the actual premium. Northwestern National Insurance Co. v. Marsh & McLennan, Inc., 817 F.Supp. 1424 (U.S.D.C., E.D. Wisconsin 1993)

The opinions of the courts cited above make it clear that in the insurance industry, a fronting agreement is a form of reinsurance. The IITA clearly provides that reinsurance premiums are not included in the apportionment factor unless they are more than 50% of total premiums. There is no exception for reinsurance premiums received through fronting arrangements. The Department's auditor was correct in excluding the amounts reported by the taxpayer as reinsurance premiums from the apportionment formula.

Remaining Issues

Taxpayer concedes that "AIA" was improperly included in the combined returns filed for 1993 and 1994, so that is no longer an issue. The remaining issues involve alternative apportionment under IITA § 304(f), the reallocation of income or deductions under IITA § 404, and penalty assessments. Because I am recommending that the "UCA", "ABC", "APEX" combined return be left standing, and that the reinsurance premiums should be excluded from the premium factor, I need not address the remaining issues except for the penalty issue.

The Department imposed a penalty under IITA § 1005 for underpayment of tax. IITA § 1005 provides for a penalty for underpayment of tax as provided by the Uniform Penalty and Interest Act. That statute, at 35 ILCS 735/3-8 and the Department's regulation, 86 Admin. Code ch. I, § 700.400, provide for waiver of penalties for late filing and late payment of tax if the failure to file or pay is due to reasonable cause. The determination of whether a taxpayer acted with reasonable cause is made on a case by case basis taking into account all of the relevant facts and circumstances. *Id.* at ¶ (b). The most important factor is evidence showing that the taxpayer made a good faith effort to comply with the law. *Id.*

The existence of reasonable cause justifying abatement of a penalty is a factual determination to be decided on a case by case basis. Kroger v. Dept. of Revenue, 284 Ill. App. 3d 473, 673 N.E. 2d 710 (citing Rohrbaugh v. U.S., 611 F.2d 211, 215 (7th Cir. 1979)). Reasonable cause generally has been interpreted to mean the exercise of ordinary business care. Kroger, supra (citing Du Mont Ventilation Co. v. Department of Revenue, 99 Ill. App. 3d 263, 266, 425 N.E. 2d 606 (1981))

The taxpayer argues that the penalty should not be assessed because there is reasonable cause. In this case, the only adjustment that I recommend be sustained is the exclusion of the reinsurance premiums from the apportionment formula. The exclusion of "AIA" from the combined returns for 1993 and 1994 is the result of the taxpayer's concession. However, taxpayer has failed to introduce any factual evidence that would demonstrate that the taxpayer acted in good faith in treating "AIA" and the reinsurance premiums as it did in its tax returns as filed. That does not show a good faith effort to comply with the law. Accordingly, there are no grounds to waive penalties.

For all of the reasons set forth above, I recommend the following:

1. The Department's Motion for Partial Summary Judgment should be stricken.
2. The Notice of Deficiency should be revised to eliminate "AIA" from the combined returns for 1993 and 1994, and the Notice of Deficiency issued to "AIA" for 1993 and 1994 should be made final.
3. The reinsurance premiums should be eliminated from the apportionment formulae.
4. Except for the exclusion of "AIA" from the unitary group for 1993 and 1994, the unitary group of "UCA", "ABC" and "APEX" should be left intact and the Notices of Deficiency, the Notice of Overassessment and the Notices of Claims Denial should be recalculated, subject to the limitation of the assessment against "APEX" of \$123,442 as specified in the agreed order filed on July 3, 2001.

ENTER: August 20, 2001

Administrative Law Judge